Northwestern Journal of International Law & Business

Volume 29
Issue 1 *Winter*

Winter 2009

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I. INTRODUCTION

Due to their recent astronomical growth, hedge funds have attracted the attention of the media, investors, investment professionals, and government regulators, not only in the United States, but in Europe as well. In 1990, there were approximately 300 hedge funds managing $39 billion in assets worldwide.[1] As of 2004, there were approximately 8000 to 9000 hedge funds managing $1 trillion[2] in assets worldwide, with current estimates reaching as high as $1.4 trillion.[3] As an industry, hedge funds have experienced an average growth rate of 20% since 1990.[4] In addition to providing investors with diverse financial instruments and investment strategies, one of the main reasons hedge funds have experienced such growth is the rate of returns they offer. For example, Caxton Corporation, a hedge fund founded in 1983, averaged annual returns of at least 30% for most of its existence.[5]

Although hedge funds offer qualified investors high returns, potential losses are severe because of the risky nature of the investment strategies

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* J.D. Candidate, 2009, Northwestern University School of Law. I wish to thank Professor David Ruder for his invaluable help on this paper. I would also like to thank the Executive and Managing Editors, as well as the Editor-in-Chief and the rest of the JILB staff for their outstanding editorial help. Last, but not least, I wish to thank my family and friends for their unending support. Any and all errors are attributable solely to myself.

[1] Sargon Daniel, Note, *Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles*, 2007 COLUM. BUS. L. REV. 247, 249.

[2] Edward Taylor & Alistair MacDonald, *Hedge Funds Get Europe's Clippers*, WALL ST. J., May 23, 2006, at C1.

[3] Shivani Vora, *Hedge-Fund Milestones*, WALL ST. J., Jan. 30, 2007, *available at* http://online.wsj.com/article/SB115394214778218146-email.html.

[4] *Id.*

[5] *Id.*

these funds utilize. Not until the near collapse of Long-Term Capital Management (LTCM) did regulators in the United States and Europe start to appreciate the systemic risk that hedge funds posed to global financial markets. However, prior to the near collapse of LTCM, hedge fund critics questioned whether hedge funds contributed to the financial conditions that led to the Asian Financial Crisis.[6] For example, Malaysian Prime Minister Mahathir bin Mohamad accused George Soros, founder of one of the world's largest hedge funds,[7] of bringing down the Malaysian currency during the Asian Financial Crisis.[8]

This comment will explore in depth the evolution of hedge fund regulation in the United States, and compare the current state of hedge fund regulation in the United States with that in Europe, specifically the United Kingdom, the European Union, and Germany. The comment is comprised of six sections. Section II provides an overview of hedge funds. Section III explores the evolution and current state of hedge fund regulation in the United States. Section IV provides an overview of the current regulatory framework of hedge funds in Europe, more specifically in the United Kingdom, the European Union, and Germany. Section V compares and contrasts the United States' hedge fund regulatory framework with that of Europe. Finally, Section VI, in light of the comparative analysis in Section V, posits recommendations aimed at improving the United States' current hedge fund regulatory framework.

The comment concludes that, after the United States' initial attempt to implement a rules-based approach in regulating hedge funds failed, the United States temporarily adopted a principles-based approach that attempted to mimic that of the United Kingdom. However, the United States' Securities Exchange Commission (SEC) recently proposed new Rules and adopted a final Rule, which seems to suggest that the United States has reverted to a rules-based approach. Moreover, the United States' rules-based approach is deficient because it does not go far enough with respect to requiring independent fund valuation, falls short of gathering adequate information about hedge funds, fails to take a risk-based approach, and, like the United Kingdom, also fails to address the threat of "empty voting."

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[6] Sherry Shore, Note, *SEC Hedge Fund Regulatory Implications on Asian Emerging Markets: Bottom Line of Bust*, 13 CARDOZO J. INT'L & COMP. L. 563, 577 (2005).

[7] Soros Fund Management LLC.

[8] Vora, *supra* note 3.

II. OVERVIEW OF HEDGE FUNDS

A. Difficulty of Defining a Hedge Fund

Despite the growing attention that hedge funds have received recently, neither U.S. nor European regulators have been able to formulate a legal or statutory definition of what constitutes a hedge fund.[9] After recognizing the difficulty in defining a hedge fund, the SEC has stated that a hedge fund usually refers to "an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act [of 1933] and which is not registered as an investment company under the Investment Company Act [of 1940]."[10]

B. Common Characteristics of a Hedge Fund

A discussion of the common characteristics of hedge funds appears to be more insightful in defining the dimensions of whether an investment vehicle constitutes a hedge fund.[11] The first characteristic that is common to hedge funds is that the funds are usually organized as limited liability corporations or limited partnerships in order to give the hedge fund manager maximum control in investing the assets of the fund.[12] Secondly, the investors of the fund are usually characterized as limited partners in the fund and are acquired through private placements, rather than public offerings.[13] A third common characteristic of hedge funds is a lock-in[14] period of two years or less.[15] Finally, hedge fund managers often charge a management fee and a performance incentive fee, which are usually 2% and 20% of fund profits, respectively.[16]

C. Types of Hedge Funds and Their Investment Strategies

There are mainly two types of hedge funds, which are distinguished on the basis of the investment strategies they employ.[17] One type of hedge

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[9] Lartease Tiffith, *Hedge Fund Regulation: What the FSA is Doing Right and Why the SEC Should Follow the FSA's Lead*, 27 NW. J. INT'L L. BUS. 497, 500 (2007).

[10] SEC STAFF REPORT, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, at viii (Sept. 2003) *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter 2003 HEDGE FUND REPORT].

[11] Daniel, *supra* note 1, at 251.

[12] Tiffith, *supra* note 9, at 500.

[13] *Id.*

[14] The "lock-in period" refers to the period of time during which an investor is not allowed to liquidate his investment or take his or her money out of the fund.

[15] 2003 HEDGE FUND REPORT, *supra* note 10, at 139–40.

[16] Tiffith, *supra* note 9, at 500.

[17] Kevin Dowd, *Too Big to Fail? Long-Term Capital Management and the Federal Reserve*, Cato Briefing Papers, Sept. 23, 1999, at 2.

fund is the macro fund, which usually takes speculative positions[18] based on its analysis of financial and macroeconomic conditions.[19] This type of hedge fund is usually highly-leveraged, meaning that "the amounts invested in [its] portfolios, the [fund's] assets, are much greater than [its] share capital, with investments in excess of capital being financed by borrowing."[20] Thus, the more leveraged a fund is, the higher the profits investors will realize if the investment is successful.[21] Equally, if a hedge fund is highly-leveraged, investors will experience a greater severity of loss[22] if the investment fails than they would have experienced had the fund not been as highly-leveraged. Hedge fund managers can obtain leverage through different means, such as financing, purchasing securities on margin, and executing derivative transactions.[23] To mitigate the high level of risk that is associated with highly-leveraged hedge funds, lenders and counterparties may require a certain level of capital as collateral for the credit extended, thereby effectively lowering the fund's asset-to-capital ratio.[24]

The other type of hedge fund is the arbitrage fund, which seeks to exploit price discrepancies in different financial markets primarily through "short selling."[25] Short selling is an investment strategy whereby a fund borrows an asset[26] and then sells the asset in anticipation of the price falling. If the price of the asset falls, the stock is repurchased at the lower price, thereby resulting in a profit for the fund. The discussion of these two types of hedge funds is not to suggest that they are mutually exclusive.

D. The Advantages and Disadvantages of Hedge Funds

One advantage of hedge funds is that they provide liquidity[27] to

[18] *Id.* (since this type of hedge fund takes speculative positions, it is "un-hedged," and thus is a hedge fund in name alone).

[19] *Id.*

[20] *Id.*

[21] The success of the investment is dependent on whether profits exceed the cost of borrowing.

[22] If the cost of borrowing exceeds the profit yield, then losses are likely to be great, possibly to the point of insolvency.

[23] Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 686 (2000).

[24] *Id.*

[25] *Id.*; Dowd, *supra* note 17, at 2.

[26] Gibson, *supra* note 23, at 686 (although the asset usually being sold is a stock, other assets may include instruments such as options, futures, swaps, currencies, and other instruments of value).

[27] The term "liquidity" means that an asset can easily be traded without having a significant change on the price of the asset.

financial markets by trading against the market.[28] Through short selling, hedge funds reduce price discrepancies in financial markets.[29] In other words, by constantly seeking to exploit price differences that may exist across financial markets, hedge funds end up smoothing out price discrepancies in different financial markets. Moreover, the strategies that hedge funds employ reallocate risk from investors who tend to be risk-averse to investors who are risk-prone investors.[30] Finally, given the plethora of investment instruments and strategies they offer qualified investors, hedge funds provide investors with portfolio diversification opportunities that are consistent with each investor's level of risk.[31]

On the other hand, hedge funds have their fair share of disadvantages. One disadvantage of hedge funds is the systemic risk that highly-leveraged hedge funds pose to global financial markets.[32] Systemic risk refers to "the risk that a major market participant's losses in the financial markets may cause widespread loss to other firms in the market, or cause disruptions to other industries or to the entire worldwide financial system."[33] In other words, a hedge fund's increased use of leverage increases the possibility that the hedge fund's losses could be transmitted to creditors, counterparties, as well as market participants who are not affiliated with the hedge fund, thereby causing a "domino effect" of financial losses across markets.[34]

The SEC has cited the use of hedge funds for fraudulent purposes as another disadvantage.[35] In fact, between 1999 and 2004, the SEC brought fifty-one cases of hedge fund fraud totaling $1.1 billion in losses to investors.[36]

A third disadvantage is the growing exposure of smaller, unsophisticated investors to hedge funds.[37] The SEC explained that while

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[28] Dale Oesterle, Foreword, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL. BUS. L. J. 1, 6 (2006).

[29] Tiffith, *supra* note 9, at 503–04.

[30] Gibson, *supra* note 23, at 688.

[31] *Id.* at 686–87.

[32] *Id.* at 705; DEP'T OF THE TREASURY ET AL., REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT, at 20 (1999) *available at* http://www.ustreas.gov/press/releases/reports/hedgfund.pdf [hereinafter 1999 PWG REPORT]; Tiffith, *supra* note 9, at 503–04.

[33] Alex McClean, *The Extraterritorial Implications of the SEC's New Rule Change to Regulate Hedge Funds*, 38 CASE W. RES. J. INT'L. L. 105, 122 (2006).

[34] Gibson, *supra* note 23, at 705–06.

[35] Registration Under the Advisors Act of Certain Hedge Fund Advisers, Advisers Act Release No. IA-2333, 72056, 17 C.F.R. Parts 275 and 279 (2004) [hereinafter Advisers Act Release].

[36] *Id.*

[37] *Id.* at 72057.

hedge funds may be appropriate investment vehicles for wealthy and institutional investors, they are inappropriate investment funds for smaller, unsophisticated investors who are not in the position to demand disclosure, appreciate the risk of their investment strategies, or incur the potentially crippling financial losses.[38]

Another disadvantage of hedge funds that has recently come to light and warrants a closer look is the ability of activist hedge funds to prompt or block corporate takeovers.[39] Hedge funds, by and large, are able to affect corporate takeovers and shareholder elections through "empty voting," which is the practice of borrowing shares of corporate stock and holding more votes than the borrower's ownership interest entitles him or her to.[40] In other words, this process enables someone other than the true owner of corporate stock to vote those shares. The opportunity for empty voting arises when brokerage firms or institutional fund managers lend the shares of their investors to hedge funds, thereby also lending the right to vote those shares.[41] Thus, if a hedge fund borrows a sufficient number of shares of stock before the record date, it can vote those shares to either promote or block takeovers depending on which course of action is more profitable for the fund.

The practice of empty voting has troubled regulators and investor advocacy groups for two reasons. First, this practice enables hedge funds to create a "self fulfilling prophesy" of sorts by allowing them to vote shares of a company that they may intend to short sell.[42] In other words, it enables hedge fund managers to manipulate the market by voting shares of borrowed stock in such a way that will drop the stock's value, thus enabling them to repurchase the stock when the price falls.

Second, empty voting undermines a fundamental principle of corporate law and governance, which is the unity between voting power and economic ownership of stock.[43] The rationale behind the coupling of voting and economic ownership is that if an investor has an economic stake in the corporation, then he or she is incentivized to vote his or her shares in such a way as to maximize the value of the corporation.[44] However, there is no incentive to do so if voting and ownership are "de-coupled." Neither

[38] *Id.* at 72057–58

[39] *See* Henry Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Kara Scannell, *How Borrowed Shares Swing Company Votes*, WALL ST. J., Jan. 26, 2007 (on file with author).

[40] Hu & Black, *supra* note 39, at 812.

[41] Scannell, *supra* note 39 (stating brokerage firms or institutional fund managers lend voting shares for a fee, and that the practice of empty voting has developed into an $8 billion industry).

[42] *Id.*; Hu & Black, *supra* note 39, at 812.

[43] Hu & Black, *supra* note 39, at 811.

[44] *Id.*

the SEC nor the Financial Services Authority (FSA), the United Kingdom's securities regulatory body, has addressed hedge funds' use of empty voting to affect corporate governance.[45]

III. THE UNITED STATES' REGULATORY FRAMEWORK OF HEDGE FUNDS

Traditionally, hedge funds were unregulated because they usually qualified for an exemption under the Securities Act of 1933,[46] the Securities Exchange Act of 1934,[47] the Investment Company Act of 1940,[48] and the Investment Advisors Act of 1940.[49] In 2004, the SEC passed a new Rule (the Hedge Fund Rule) under the Investment Advisers Act to close the section 203(b) exemption, which, in effect, would subject an overwhelming majority of hedge funds to SEC registration and regulation.[50] However, in *Goldstein v. SEC*,[51] the Court of Appeals for the D.C. Circuit struck down the Hedge Fund Rule as "arbitrary."[52] In light of the SEC's decision not to appeal the *Goldstein* decision,[53] the current state of hedge fund regulation has reverted back to its pre-amended Advisers Act state, which effectively exempts hedge funds from SEC registration and regulation. However, in 2007, the President's Working Group on Financial Markets (PWG) released a report (2007 PWG Report) setting out principles and guidelines designed to provide regulators with guidance in their oversight of hedge funds.[54] The 2007 PWG Report concluded that "[p]ublic policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk."[55]

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[45] Scannell, *supra* note 39.

[46] 15 U.S.C. §§ 77a–77aa (2005) [hereinafter Securities Act].

[47] 15 U.S.C. §§ 78a–78nn (2007) [hereinafter Exchange Act].

[48] Investment Company Act of 1940, 15 U.S.C. §§ 80a-1–80a-64 (2007) [hereinafter Investment Company Act].

[49] Investment Advisers Act of 1940, 15 U.S.C. § 80b-1–80b-21 (2007) [hereinafter Advisers Act]; Sean M. Donahue, Note, *Hedge Fund Regulation: The Amended Investment Advisers Act Does Not Protect Investors From the Problems Created by Hedge Funds*, 55 CLEV. ST. L. REV. 235, 249 (2007).

[50] *See* Advisers Act Release, *supra* note 35, at 72058.

[51] 451 F.3d 873 (D.C. Cir. 2006).

[52] *Id.* at 884.

[53] Press Release 2006-135, Sec. Exch. Comm'n, Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in *Phillip Goldstein, et al. v. SEC* 2006-135 (Aug. 7, 2006), *available at* http://www.sec.gov/news/press/2006/2006-135.htm [hereinafter SEC Press Release 2006-135].

[54] PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL (Feb. 22, 2007), 1, *available at* http://www.treas.gov/press/releases /reports/hp272 _principles.pdf [hereinafter 2007 PWG Study].

[55] *Id.* at 1.

Despite the D.C. Circuit's holding in *Goldstein* that the Hedge Fund Rule was "arbitrary" and the 2007 PWG Report recommending a principles-based approach, the SEC's adoption of Rule 206(4)-8 under the Advisers Act and proposal of Rules 216 and 509 under the Securities Act seem to suggest that the SEC has not abandoned its rule-based approach to regulating hedge funds.

A. The Securities Act of 1933

The main objective of the Securities Act is to promote efficient capital formation while ensuring that firms seeking to obtain capital from the public provide full and fair disclosure to the public.[56] To that end, Section 5 of the Securities Act prohibits selling or offering to sell unregistered securities, as well as selling securities without delivering a prospectus containing certain information about the issuer.[57] Hedge funds, which often offer interests in a limited partnership, limited liability corporate partnership, or other legal entities, fall within the Securities Act's definition of "security" that must be registered.[58] However, hedge funds rely on Section 4(2)'s private offering exemption to avoid the registration and prospectus delivery requirements under Section 5.[59] Nevertheless, this exemption is "limited to situations where the offerees have access to the kind of information afforded by registration under Section 5 of the Securities Act."[60]

Since it would be impractical for a hedge fund manager to ensure that all investors receive the same disclosure they would otherwise receive under Section 5, hedge funds rely on Rule 506 of Regulation D for an exemption.[61] Rule 506 of Regulation D provides a private offering exemption if an issuer has no more than thirty-five purchasers,[62] who are not "accredited investors,"[63] and does not advertise publicly.[64] A hedge

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[56] JOHN C. COFFEE ET AL., SECURITIES REGULATION: CASES AND MATERIALS 88 (2007).

[57] Securities Act, *supra* note 46, §§ 5(a)–5(c).

[58] Tiffith, *supra* note 9, at 509.

[59] *Id.* at 509–10.

[60] Daniel, *supra* note 1, at 258 (citing 2003 HEDGE FUND REPORT, *supra* note 10).

[61] *Id.*

[62] *Id.* at 259 (citing 17 C.F.R. § 230.506(b)(2)(i)).

[63] *Id.* (citing 17 C.F.R. § 230.501(a)(2006)). "Accredited investor" is defined as:

> (i) Individuals who have a net worth, or joint worth with their spouse, above $1,000,000, or have income above $200,000 in the last two years (or joint income with their spouse above $300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and [(ii)] certain institutional investors, including banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies;

fund that seeks to avail itself of the Section 4(2) private offering exemption through Rule 506 is advised to be very careful in its solicitation because a mere interview or internet posting may constitute a general solicitation to the public, which would thereby void the exemption.[65]

Thus, hedge funds are usually exempt from registering with the SEC under Section 5 if they sell mainly to accredited investors and neither exceed the thirty-five purchaser threshold for non-accredited investors nor solicit publicly. Unlike other exemptions, a Rule 506 exemption is very attractive to hedge funds because there is no monetary limit on the fund.

B. The Securities Exchange Act of 1934

Under the Securities Exchange Act of 1934 (the Exchange Act), a dealer in securities, or "any person engaged in the business of buying and selling securities for such person's own account . . . ." is required to register with the SEC.[66] Thus, hedge funds fall within the regulatory scope of the Exchange Act because they qualify as "dealers" in securities or "person[s] who sell and buy securities for their own account."[67] Section 12(g) of the Exchange Act requires a dealer whose assets are held by more than 500 people and has assets in excess of $1 million by the end of its most current fiscal year to register.[68] Thus, hedge funds are able to avoid having interests in their funds considered securities by not having more than 499 investors in each fund.

C. The Investment Company Act of 1940

Under the Investment Company Act of 1940 (the Investment Act), investment companies or companies that invest in pooled funds of small investors are required to register with the SEC and are thus subject to regulation.[69] Thus, virtually every hedge fund would fall under the purview of the Investment Act because they constitute either investment companies or companies that pool investment funds. However, section 3(c)(1) and section 3(c)(7) provide hedge funds with two separate exemptions from registering under the Investment Act.

Section 3(c)(1) exempts "[a]ny issuer[70] whose outstanding

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corporations; partnerships; limited liability companies and business trusts with more than $5,000,000 in assets.

[64] Securities Act, *supra* note 46, § 230.506.
[65] Coffee, *supra* note 56, at 88.
[66] Exchange Act, *supra* note 47, § 78c(a)(5).
[67] *Id.*
[68] Exchange Act, *supra* note 47, § 78l.
[69] *See generally* Investment Company Act, *supra* note 48.
[70] As mentioned earlier, hedge funds would be considered issuers since they offer

securities . . . are beneficially-owned by not more than one hundred persons and which is not making a public offering of its securities"[71] from the definition of an investment company under the Investment Act. Generally, hedge funds qualify for a section 3(c)(1) exemption.[72] However, the exemption is unavailable if either one of the exemption's two requirements is not satisfied.[73] The first requirement is that a fund must have fewer than 100 investors. Each individual investor is considered a beneficial owner, unless the investor is an "investing entity," which is an entity that owns at least 10% of the hedge fund's voting securities.[74] If an investor is deemed to be an investing entity, then a hedge fund is required to look through the investing entity and count each beneficial owner of the entity as an investor.[75] The second requirement is that the offering be private, or non-public.[76]

Section 3(c)(7) exempts "[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of the acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities."[77] Section 2(a)(51)(A) defines a "qualified purchaser" as any person who owns at least $5 million in investments.[78] The rationale behind the section

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investors interests in the fund as limited partnerships or limited liability company memberships, which would constitute a security.

[71] Investment Company Act, *supra* note 48, § 3(c)(1).

[72] Gibson, *supra* note 23, at 694.

[73] *Id.*

[74] *Id.* at 694–95.

[75] *Id.*

[76] *Id.*

[77] Investment Company Act, *supra* note 48, § 3(c)(7).

[78] Investment Company Act, *supra* note 48, § 2(a)(51)(A). This section actually provides four alternative definitions of who or what constitutes a "qualified purchaser," the most relevant of which is the one provided in the text. Section 2(a)(51)(A) defines a "qualified purchaser" as:

> (i) [A]ny natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 80a-3(c)(7) of this title with that person's qualified purchaser's spouse) who owns not less than $5,000,000 in investments, as defined by the Commission;
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> (ii) [A]ny company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;
>
> (iii) [A]ny trust that is not covered by clause (ii) and that was not formed for the

3(c)(7) exemption is that wealthy sophisticated investors are not in need of the protection provided by the securities laws because they either possess the knowledge to appreciate risky investments or have the financial means to absorb the loss from a risky investment.

Nevertheless, a hedge fund would qualify if it only sells securities to qualified investors and does not make or propose to make a public offering. Section 3(c)(7), unlike Section 3(c)(1), does not limit the number of investors in a fund.[79] However, hedge funds usually limit the number of investors to less than 500 to avoid registration under the Exchange Act.[80]

D. Investment Advisers Act of 1940

The Investment Advisers Act of 1940 (the Advisers Act) requires investment advisers to register with the SEC and comply with Rules promulgated by the SEC, which regulate investment advisers' practices and conduct.[81] The purpose of the Advisers Act is to protect investors who rely on the advice of investment advisers by providing them (and the SEC) with current information on investment advisers.[82] Section 2(a)(11) of the Advisers Act defines an "investment adviser" as:

> [A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of the securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[83]

At first glance, it would appear that hedge funds fall squarely within the definition of an investment adviser since they advise clients on a host of investment instruments, strategies, and opportunities. However, Rule 203(b)'s small adviser or *de minimis* exemption exempts from registration "any investment adviser who during the course of the preceding twelve

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specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settler or other person who has contributed assets to the trust, is person described in clause (i), (ii), or (iv); or

(iv) [A]ny person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.

[79] Gibson, *supra* note 23, at 695–96.
[80] *Id.* at 696.
[81] *See* Investment Advisers Act, *supra* note 49.
[82] Gibson, *supra* note 23, at 696.
[83] Investment Advisers Act, *supra* note 49, § 2(a)(11) [15 U.S.C. § 80b-2(a)(11)].

months has had fewer than *fifteen* clients and who neither holds himself out generally to the public as an investment adviser nor acts [as] an investment advisor to an investment company . . . [or] a business development company . . . ."[84] In other words, as long as a hedge fund has not had more than fourteen clients in the last twelve months and has not held itself out as an investment adviser, it is exempt from registering as an investment adviser under the Advisers Act. It is crucial to point out that prior to the SEC's adoption of the Hedge Fund Rule in 2004, hedge funds were not required to "look through" each fund and count the number of investors in each fund of pooled investments. Rather, each fund counted as one client, irrespective of the number of investors within that fund.[85]

E. SEC Passes the Hedge Fund Rule Under the Investment Advisers Act of 1940

1. *The Near Collapse of Long-Term Capital Management*

U.S. regulators did not pay hedge funds much attention until the near collapse of LTCM in 1998. LTCM was a large, highly-leveraged[86] macro hedge fund that used complex investment strategies to exploit arbitrage opportunities in foreign financial markets.[87] LTCM had speculated heavily that spreads between the prices of Western government and emerging-market bonds, specifically Russia, would become narrower.[88] However, after the Russian government devalued the ruble and put a halt on future debt repayments, the creditworthiness of emerging-market bonds deteriorated, thereby expanding the spread between Western government and emerging-market bonds.[89] As a result, LTCM lost over half of its equity capital, causing fear that the unraveling of LTCM would threaten the stability of the international bond market.[90] Fortunately, a bailout was orchestrated by the New York Federal Reserve which saved LTCM from insolvency.[91] However, the fallout from the near collapse of LTCM attracted the attention of the U.S. Congress, which led the SEC to consider regulating the hedge fund industry.[92]

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[84] Investment Advisers Act, *supra* note 49, at R. 203(b)(3) [15 U.S.C. § 80b-3(b)(3)] (emphasis added).

[85] Advisers Act Release, *supra* note 35, at 72058.

[86] Tiffith, *supra* note 9, at 506 (stating that LTCM's debt-to-equity ratio was once 42:1).

[87] McClean, *supra* note 33, at 115.

[88] Dowd, *supra* note 17, at 3–4.

[89] *Id.*

[90] McClean, *supra* note 33, at 116.

[91] *Id.*

[92] *Id.*

2. *The Report on Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (1999)*

On April 28, 1999, the PWG released its report on the near collapse of LTCM and the lessons learned from the incident.[93] According to the report, one lesson that arose out of the near collapse of LTCM was that highly-leveraged financial institutions can increase the level of systemic risk to global financial markets.[94] Moreover, although market discipline[95] is an effective tool to minimize the risk from excessive leverage, there are some cases in which market discipline fails because creditors may either lack the incentive or the means to evaluate the riskiness of a firm.[96] As a corollary to the possibility of market discipline failure, it appears that, in some cases, highly-leveraged firms do not provide creditors, counterparties, or investors with sufficient disclosure for these parties to evaluate their exposure to risk. After the near collapse of LTCM, the interconnectedness of global financial markets became apparent. However, the PWG ultimately recommended against hedge fund regulation.[97]

3. *The SEC's Staff Report on the Implications of the Growth of Hedge Funds (2003)*

After the significant growth in the size and influence of hedge funds, the SEC's Staff launched an investigative study aimed at reviewing the operations and practices of hedge funds.[98] The report identified areas of concern to the Staff as well as potential recommendations to address these concerns.[99]

One area of concern to the Staff was that the SEC lacked information about hedge fund advisers, and thus the SEC was unable to evaluate the effects of the investment strategies used by hedge funds.[100] Moreover, the Staff expressed concern over the lack of regulatory measures which would ensure that hedge funds provide investors with sufficient disclosure to make informed investment decisions.[101]

The Staff was also concerned that hedge fund investors may not have sufficient information about hedge fund advisers and the advisers'

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[93] *See* 1999 PWG REPORT, *supra* note 32, at 1.

[94] *Id.* at 32.

[95] *Id.* at 25 (defining "market discipline" as the process through which creditors and counterparties increase the cost of credit or reduce credit to firms when such firms expose creditors and counterparties to increased levels of risk through excessive leverage).

[96] *Id.* at 25–26.

[97] *Id.* at 42.

[98] *See* 2003 HEDGE FUND REPORT, *supra* note 10.

[99] *Id.*

[100] *Id.* at x.

[101] *Id.*

management of the fund.[102] In addition, there was concern that hedge fund advisers did not disclose potential conflicts of interest to hedge fund investors.[103]

The Staff's main concern was the lack of independent review over the process through which hedge fund advisers value their funds' assets.[104] This deficiency not only raised questions about the true value of a hedge fund's assets, but also raised concerns about the ability of registered funds (that invest in hedge funds) to accurately value their interests in hedge funds.[105]

After identifying areas of concern, the SEC Staff made recommendations aimed at addressing these concerns. First, the Staff recommended that the SEC consider passing a new Rule requiring hedge fund advisers to register with the SEC as investment advisers under the Advisers Act, while taking into account whether the benefits outweigh the burdens of registration.[106] Second, the SEC Staff suggested that the SEC consider addressing issues with respect to advisers' valuation of hedge fund assets, suitability, and fee disclosure relating to registered funds of hedge funds (FOHF).[107] Third, the Staff advised the SEC to encourage the hedge fund industry to establish and further develop industry-wide best practices.[108] Finally, the Staff advised the Commission to maintain its current efforts to improve investor education about hedge funds.[109]

4. *The Hedge Fund Rule—Registration Under the Advisers Act of Certain Hedge Fund Advisers*

On December 2, 2004, the SEC took up the Staff's recommendation to pass a new Rule requiring hedge fund advisers to register with the SEC as investment advisers, and passed the Hedge Fund Rule.[110] The SEC justified the Hedge Fund Rule based on the concerns raised in the 2003 Staff Report as well as new concerns that had come to light since the 2003 report.[111] The SEC mentioned as a new concern the growing exposure of non-

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[102] *Id.* at xi.

[103] *Id.*

[104] 2003 HEDGE FUND REPORT, *supra* note 10, at xi.

[105] *Id.*

[106] *Id.*

[107] *Id.* at xii; SEC, Hedging Your Bets: A Heads up on Hedge Funds and Fund of Hedge Funds, What are "Funds of Hedge Funds"?, http://www.sec.gov/answers/hedge.htm (defining a fund of hedge funds as "an investment company that invests in hedge funds—rather than investing in individual securities").

[108] 2003 Hedge Fund Report, *supra* note 10, at xiii.

[109] *Id.*

[110] Advisers Act Release, *supra* note 35, at 72059.

[111] *Id.* at 72059–67.

qualified investors to hedge funds through public and private pension funds, university endowments, foundations, and charitable organizations that invest in hedge funds.[112]

The Hedge Fund Rule requires hedge funds to "look through" each private fund and count each investor as a "client" towards the fourteen client threshold for Rule 203(b)-3's private adviser exemption.[113] The SEC stated that the Hedge Fund Rule:

> [W]ould require hedge fund advisers to count each *investor* in a fund, rather than only the hedge fund itself, as a *client* for purposes of the private adviser exemption. As a result, most hedge fund advisers would have to register with the Commission and would be subject to SEC oversight.[114]

Moreover, the Hedge Fund Rule redefined "private fund" to fit the mold of a hedge fund.[115] The definition was based on three characteristics[116] which distinguished hedge funds from other types of private funds, such as private equity and venture capital funds.[117]

F. The Hedge Fund Rule Struck Down as "Arbitrary" in *Goldstein v. SEC*

Eight days after the SEC announced the adoption of the Hedge Fund Rule, Phillip Goldstein, an investment advisory firm, brought suit challenging the Hedge Fund Rule's equation of "client" with "investor."[118] Goldstein argued that the SEC misinterpreted the Advisers Act because the word "client," traditionally and rightly, referred to the actual fund, not the number of investors in the fund.[119] The Advisers Act does not define the word "client."[120] The SEC argued that since the Advisers Act does not define "client" the Advisers Act is "ambiguous as to the method of counting clients."[121] The Court of Appeals for the D.C. Circuit held that the SEC's Hedge Fund Rule was "arbitrary" because "there [was] a disconnect

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[112] *Id.* at 72057–58 In addition, the Commission mentioned growing hedge fund fraud as a new concern. *See id.* at 72058.

[113] *Id.* at 72058.

[114] *Id.* (emphasis added) (citations omitted).

[115] *Id.* at 72068–69.

[116] Adviser's Act Release, *supra* note 35, at 72073 (stating that the three characteristics are: (1) whether a fund is exempt from the Investment Company Act under either § 3(c)(1) or § 3(c)(7), (2) a lock-in period of two years, and (3) whether the only interest in the fund is based on the advisory skills of the investment advisor).

[117] *Id.*

[118] Goldstein v. SEC, 451 F.3d 873, 874 (D.C. Cir. 2006).

[119] *Id.* at 878.

[120] *Id.*

[121] *Id.*

between the factors the [SEC] cited and the Rule it promulgated."[122] The Court reasoned that just because the Advisers Act did not define the word "client" did not mean that Congress authorized an agency to define the word by default.[123] In fact, the Court pointed out that the legislative history suggests that Congress understood "client" to refer to investment company entities themselves, not the investors in those entities.[124]

G. Post-*Goldstein* Hedge Fund Regulation

After the SEC decided not to appeal the *Goldstein* decision,[125] it became apparent that the SEC's initial attempt to implement a rules-based approach in regulating hedge funds had failed. Initially, it was unclear whether the SEC would abandon its rules-based approach for a principles-based approach or if it would continue its rules-based approach in regulating hedge funds. In early 2007, the PWG released a set of principles to guide U.S. regulators in their oversight of hedge funds.[126] The PWG's release seemed to suggest that U.S. regulators initially considered adopting a principles-based approach post-*Goldstein*.

Ultimately, that proved not to be the case. Shortly after the PWG's release, the SEC published three releases: the Private Pooled Investment Vehicle Release,[127] the Prohibition of Fraud by Advisers Release,[128] and the Revisions of the Limited Offering Release,[129] culminating in the adoption of new final Rule 206(4)-8 under the Advisers Act, the proposal of three new Rules (Rules 216, 507 and 509 under the Securities Act), and the proposed revision to the Rule 501(a) accredited investor qualification standards. The new final Rule, the three new proposed Rules, and the proposed revision to Rule 501(a) seem to suggest that the SEC has not abandoned its pre-*Goldstein* rules-based approach in regulating hedge funds.

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122 *Id.* at 882–84.

123 *Id.* at 878.

124 *Goldstein*, 451 F.3d at 879–80.

125 *See generally* SEC Press Release 2006-135, *supra* note 53.

126 2007 PWG STUDY, *supra* note 54.

127 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles: Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 8766, Investment Advisers Act Release No. 2576, 72 Fed. Reg. 399 (proposed Dec. 27, 2006) [hereinafter Private Pooled Investment Vehicle Release].

128 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, 72 Fed. Reg. 44756 (released Aug. 3, 2007) (effective Sept. 10, 2007) [hereinafter Prohibition of Fraud by Advisers Release].

129 Revisions of Limited Offering Exemption in Regulation D, Securities Act Release No. 8828, 72 Fed. Reg. 45116 (proposed Aug. 3, 2007) [hereinafter Revision of Limited Offering Exemption Release].

1. The Agreement Among the President's Working Group and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital

On February 22, 2007, the PWG released a set of principles that was aimed at providing regulators guidance in their oversight of private pools of capital, including hedge funds.[130] The ten principles mainly focused on systemic risk and investor protection. The PWG stated that "[p]ublic policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk."[131]

With respect to systemic risk,[132] the PWG stated that the most effective mechanism for mitigating systemic risk is the exercise of market discipline by creditors, counterparties, and investors.[133] In other words, creditors and counterparties, who are generally large, sophisticated financial firms, have the proper incentives and expertise to adjust the credit available to hedge funds according to the level of risk and the fund's valuation methodology.

Moreover, the PWG advised creditors and counterparties to establish policies, procedures, and protocols that address "how the quality of information from a private pool of capital should affect margin, collateral, and other credit terms and other aspects of counterparty risk management."[134] More specifically, creditors and counterparties should conduct due diligence, including but not limited to reviewing a fund's ability to appropriately measure and manage its exposure to market, credit, liquidity, and operational risk.[135] As part of their due diligence inquiry, creditors and counterparties were advised to conduct rigorous stress testing[136] which takes into account adverse market liquidity that would result from several market participants unwinding transactions simultaneously.[137]

Fund managers should have valuation, risk management, and information systems that meet industry standards and enable them to

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[130] 2007 PWG STUDY, *supra* note 54, at 1.

[131] *Id.*

[132] *Id.* at 3 (defining "systemic risk" as the "possibility that losses at one or more entities could threaten the stability of the broader financial system.").

[133] *Id.* (Principle 6).

[134] *Id.* at 3–4 (Principle 7).

[135] *Id.* at 4 (Principle 7.1).

[136] 2007 PWG Study, *supra* note 54, at 4 (describing "stress testing" as the process through which one can "quantify the impact of adverse market events, both at the level of an individual counterparty and aggregated across counterparties.").

[137] *Id.*

provide creditors and counterparties with accurate information.[138] Where a fund does not provide sufficient information to conduct a thorough due diligence inquiry, the PWG advised creditors and counterparties to tighten margin, collateral, and other credit terms accordingly.[139]

With respect to investor protection, the PWG stated that "[i]nvestor protection concerns can be best addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors."[140] More specifically, the PWG advised investors not to expose themselves to levels of risk they cannot tolerate, given their investment objectives and portfolio diversification goals.[141] Moreover, individuals that invest in private pools of capital, such as hedge fund investors, are encouraged to obtain historical and continuous information which is necessary to perform due diligence, evaluate the investment strategies of these funds, and assess the level of risk posed by these funds.[142]

Investors were encouraged to obtain information ranging from the fund adviser's qualifications to potential conflicts of interest that the adviser might have.[143] More importantly, investors were advised to analyze the valuation methodology, performance calculation processes, and operational risk management systems used by the fund, and to ensure that there was an independent audit scheme of fund processes and systems.[144] With respect to concerns that less sophisticated investors are indirectly exposed to hedge funds through pension funds, charitable organizations, or funds of hedge funds, the PWG advised that sound practices by the fiduciaries of these funds are the best way to address such concerns.[145]

Finally, the PWG advised regulators to communicate their expectations as to what constitutes "prudent management of counterparty credit exposures,"[146] considering "developments in financial markets and advances in best practices for counterparty credit risk management."[147] Moreover, regulators were encouraged to use formal and informal channels across financial markets and borders in order to obtain information about private pools of capital.[148] Regulators were also advised to cooperate and

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[138] *Id.* at 5 (Principle 9).
[139] *Id.* at 4 (Principle 7.4).
[140] *Id.* at 1.
[141] *Id.* at 2 (Principle 3).
[142] 2007 PWG STUDY, *supra* note 54, at 2. (Principle 4).
[143] *Id.* (Principles 4.2 and 4.4).
[144] *Id.* (Principle 4.5).
[145] *Id.* at 2–3 (Principle 5).
[146] *Id.* at 6 (Principles 10 and 10.1).
[147] *Id.* at 6.
[148] 2007 PWG STUDY, *supra* note 54, at 6 (Principle 10.2).

coordinate with authorities in other countries in gathering and sharing information about these funds.[149] Ultimately, the PWG recommended a principles-based approach rather than a rules-based approach in regulating hedge funds.[150]

2. *Private Pooled Investment Vehicle Release—Proposal of Rule 206(4)-8 Under Advisers Act and Proposal of Rules 216 and 509 Under Securities Act (December 27, 2006)*

In the Private Pooled Investment Vehicle Release, the SEC proposed three new Rules designed to provide additional protection for those who invest in pooled investment vehicles, such as hedge funds.[151] Rule 206(4)-8, proposed under the Advisers Act, would prohibit investment advisers of pooled investment funds from making false or misleading statements of material fact or otherwise defrauding investors or prospective investors in those pooled funds.[152] Because the SEC adopted Rule 206(4)-8 as proposed in its Prohibition of Fraud by Advisers Release,[153] an in-depth discussion of the Rule will be deferred until Section V-B.[154]

The SEC also proposed Rules 216 and 509 under the Securities Act.[155] These Rules would revise the definition of the term "accredited investor" as it relates to natural persons but only within the context of the offer and sale of securities in privately-offered investment pools.[156] The SEC proposed these Rules because of concern that the current definition of the term "accredited investor" did not provide sufficient protection for those who invest in privately offered investment pools.[157] The SEC explained that, due to an increase in the value of investors' personal residences since 1982, many investors now qualify as accredited investors but lack the financial acumen to invest in pooled funds or the means to absorb potentially severe financial losses.[158]

In the Pooled Private Investment Release, the Commission distinguished between the Investment Company Act's definitions of investment pools under Sections 3(c)(1) and 3(c)(7).[159] The SEC pointed

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[149] *Id.*

[150] *Id.*

[151] *See generally* Private Pooled Investment Vehicle Release, *supra* note 127 (stating that these rules were proposed "with a view to strengthening protection for investors.").

[152] *Id.* at 1.

[153] *See generally* Prohibition of Fraud by Advisers Release, *supra* note 128.

[154] *See* discussion *infra* Part V-B.

[155] Private Pooled Investment Vehicle Release, *supra* note 127, at 400.

[156] *Id.*

[157] *Id.* at 404.

[158] *Id.* at 412.

[159] *Id.* at 411.

out that protections available for investors in pools relying on a Section 3(c)(7) exclusion are unavailable for investors in pools relying on a Section 3(c)(1) exclusion.[160] Currently, a natural person must meet a two-prong test to qualify for investment in a 3(c)(7) pool. First, the individual must own at least $5,000,000 in certain investments at the time of investing.[161] Second, the individual must be a "qualified purchaser" who also meets the definition of an "accredited investor."[162] Through proposed Rules 216 and 509, the SEC seeks to extend the same two-prong test to those who invest in 3(c)(1) pools.[163]

Proposed Rules 216 and 509 would only apply to the offer and sale of securities in investment vehicles as defined in the Rules and would exclude private funds, such as venture capital funds.[164] The Rules would define "private investment vehicle" to mean an issuer that would be considered an investment company absent a Section 3(c)(1) exclusion.[165]

More importantly, the Rules created a new category of accredited investor called "accredited natural person," which is defined as:

> [A]ny natural person who meets the requirements specified in the current definition of accredited person, as [that] term relates to natural persons, and would add a requirement that such person also must own (individually, or jointly with the person's spouse) not less than $2,500,000 (as adjusted every five years for inflation) in investments at the time of purchase of securities issued by private investment vehicles under Regulation D or section 4(6).[166]

In other words, to qualify as an accredited natural person for a 3(c)(1) investment pool, a person must (i) have a net worth (individually or combined with spouse) of more than $1,000,000, or have an income of more than $200,000 (or joint income with his or her spouse of more than $300,000) and reasonably expect to make the same income during the year of investment *and* (ii) own at least $2,500,000 in investments.[167]

Effectively, the proposed Rules would make it much harder for individuals to invest in pooled investment vehicles, such as hedge funds. In explaining why it added the $2,500,000-in-investment requirement, the SEC said that when Regulation D was adopted in 1982, only "1.87% of

[160] *Id.*
[161] 15 U.S.C. § 80a-2 (2007).
[162] Private Pooled Investment Vehicle Release, *supra* note 127, at 411.
[163] *Id.*
[164] *Id.* at 405.
[165] *Id.*
[166] *Id.*
[167] Regulation D, 17 C.F.R. § 230.51(a)(5)–(6) (2008); Private Pooled Investment Vehicle Release, *supra* note 127, at 405.

U.S. households qualified for accredited investor status" and were therefore able to invest in pooled investment vehicles.[168] The Commission pointed out that by 2003, the percentage had increased to 8.47% of households,[169] mainly due to an appreciation in the value of real estate.[170] However, with the proposed $2,500,000 investment requirement for individuals, only 1.3% of U.S. households would qualify for accredited natural person status.[171]

3. *Prohibition of Fraud by Advisers Release—Adoption of Final Rule 206(4)-8 (August 3, 2007)*

In the Prohibition of Fraud by Advisers Release, the SEC adopted Rule 206(4)-8 under the Advisers Act as proposed in the Private Pooled Investment Vehicle Release.[172] Final Rule 206(4)-8 effectively extends the SEC's anti-fraud Rules for registered and unregistered investment advisers to pooled investment vehicles and thereby protects investors and prospective investors in such vehicles.[173]

The purpose of Rule 206(4)-8 was to address the ambiguity in the D.C. Circuit's decision in *Goldstein*.[174] The uncertainty in the Court's decision pertained to whether the SEC has the power to bring enforcement actions under the Advisers Act against investment advisers of pooled investment vehicles who defraud investors through material misrepresentations or omissions.[175] The SEC explained that in *Goldstein*, the Court distinguished sections 206(1) and (2) from section 206(4) under the Advisers Act in that "section 206(4) . . . is not limited to conduct aimed at clients or prospective clients of [hedge funds]."[176] Section 206(4) explicitly gives the SEC the authority to "define and prescribe means reasonably designed to prevent . . . acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[177] The SEC promulgated Rule 206(4)-8 under its authority under section 206(4).[178]

More specifically, Rule 206(4)-8(a)(1) prohibits investment advisers from making false or misleading statements to investors or prospective

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[168] Private Pooled Investment Vehicle Release, *supra* note 127, at 406.

[169] *Id.*

[170] *Id.* at 407.

[171] *Id.* at 406.

[172] Prohibition of Fraud by Advisers Release, *supra* note 128, 44756 (explaining that this "new rule under the Advisers Act . . . would prohibit advisers to pooled investment vehicles from defrauding investors or prospective investors in pooled investment vehicles.").

[173] *Id.* at 44757.

[174] *Id.*

[175] *Id.*

[176] *Id.*

[177] 15 U.S.C. § 80b-6.

[178] Prohibition of Fraud by Advisers Release, *supra* note 128, at 44757.

investors in pooled investment vehicles.[179] With respect to current investors, the Rule forbids the making of false or misleading statements in account statements.[180] Further, the Rule prohibits advisers from making false or misleading statements in "private placement memoranda, offering circulars, or responses to 'requests for proposals,' electronic solicitations, and personal meetings arranged through capital introduction services."[181]

Rule 206(4)-8(a)(2) makes it illegal for an adviser to "otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in [a] pooled investment vehicle."[182]

Rule 206(4)-8 also clarifies that an adviser's duty to refrain from fraudulent conduct against the fund also extends to "ultimate investors" and that the SEC may bring enforcement actions against advisers who defraud current or prospective investors in hedge funds or other pooled investment vehicles.[183] Moreover, the Rule applies to both registered and unregistered investment advisers.[184]

Rule 206(4)-8 defines a pooled investment vehicle as "any investment company defined in section 3(a) of the Investment Company Act and any privately offered pooled investment vehicle that is excluded from the definition of investment company by reason of either section 3(c)(1) or 3(c)(7) of the Investment Company Act."[185] In other words, the Rule applies to private equity funds, venture capital funds, hedge funds, and other pools that invest in securities.[186]

Unlike Rule 10b-5 under the Exchange Act, the SEC need not show that an adviser acted with scienter under Rule 206(4)-8.[187] Thus, negligently or recklessly deceptive behavior falls within the scope of the Rule. Finally, Rule 206(4)-8 creates neither a fiduciary duty between advisers and investors or prospective investors nor a private right of action.[188]

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[179] 17 C.F.R § 275.206(4)-8(a)(1) (2008).

[180] Prohibition of Fraud by Advisers Release, *supra* note 128, at 44757.

[181] *Id.* at 44758.

[182] 17 C.F.R. § 275.206(4)-8(a)(2) (2008).

[183] Prohibition of Fraud by Advisers Release, *supra* note 128, at 44757 (stating that "an adviser's duty to refrain from fraudulent conduct under the federal securities laws extends to the relationship with the ultimate investor.").

[184] *Id.* at 44758.

[185] *Id.*

[186] *Id.*

[187] *Id.* at 44759.

[188] *Id.* at 44760.

4. *Revision of Limited Offering Exemption Release (August 3, 2007)*

In the Revision of Limited Offering Exemption Release, the SEC proposed revisions to the limited offering exemption in Regulation D.[189] There were four parts to the revision. First, the SEC proposed new Rule 507, which created a new exemption from registration under the Securities Act for offers and sales of securities to "large accredited investors."[190] Second, the SEC proposed to revise the definition of the term "accredited investor" under Rule 501(a) of Regulation D to reflect developments since the Rule's adoption.[191] Third, the SEC proposed to shorten the time required by the integration safe harbor.[192] Finally, the Commission proposed uniform disqualification provisions to all offerings seeking to rely on Regulation D.[193] For the sake of brevity, I will discuss only the first two parts.

Proposed Rule 507 would create a new exemption from the registration provisions under the Securities Act for offers and sales of securities to "large accredited investors." Under Proposed Rule 507, an investments-owned standard is substituted for the assets-owned standard.[194] Moreover, in order for a legal entity or institutional investor to achieve large accredited investor status it must have at least $10,000,000 in investments rather than the current Rule 501(a) requirement of $5,000,000 in assets.[195] Individuals, or "natural persons" must have at least $2.5 million in investments *or* have an annual income of $400,000 (or $600,000 combined income with spouse) to qualify as a large accredited investor, rather than the current Rule 501(a) standard of $1,000,000 in assets or $200,000 annual income (or $300,000 combined income with spouse) for an accredited investor.[196]

The proposed Rule would permit limited advertising that satisfies the requirements of Rule 507, though general solicitations are still prohibited.[197] Announcements would be required to state that (i) offers or sales are only extended to large accredited investors, (ii) no money or consideration will be accepted through the announcement, (iii) securities have not been registered or approved by the SEC, and (iv) the offering was made pursuant to an exemption.[198]

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[189] *See* Revision of Limited Offering Exemption Release, *supra* note 129.
[190] *Id.* at 45117.
[191] *Id.* at 45122.
[192] *Id.* at 45128.
[193] *Id.* at 45133.
[194] *Id.* at 45119.
[195] Revision of Limited Offering Exemption Release, *supra* note 129, at 45118.
[196] *Id.*
[197] *Id.* at 45120.
[198] *Id.*

Under the proposed revision to Rule 501(a)'s accredited investor standard, there would be an alternative investments-owned standard to the current assets-owned standard.[199] Legal entities or institutional investors would be able to achieve accredited investor status by owning at least $5,000,000 in investments.[200] Individuals would be able to achieve accredited investor status by owning at least $750,000 in investments, rather than the current net worth or income thresholds.[201] Moreover, the SEC proposed to adjust the dollar-amount thresholds to reflect inflation every five years.[202]

IV. EUROPE'S REGULATORY FRAMEWORK FOR HEDGE FUNDS

A. The United Kingdom's Regulatory Framework of Hedge Funds

The approach taken by the Financial Services Authority (FSA), the regulatory body of financial markets in the United Kingdom, for regulating hedge funds is a principles-based approach. This approach contrasts with the SEC's rules-based approach. In its oversight of hedge funds, the FSA has focused on risks associated with market stability, investor protection barriers, and valuation standards.[203]

As part of its principles-based approach, the FSA identifies threats to the stability of financial markets, and then allocates resources to monitoring such threats depending on their severity.[204] For example, the FSA established the Center for Hedge Fund Supervision (the Center), which is charged with the responsibility of supervising twenty of the United Kingdom's largest hedge funds.[205] These funds may either have significant market impact or pose a great risk to financial markets. The Center is responsible for "relationship management of high-impact hedge fund managers, driving relevant thematic work and support authorization, enforcement and public initiatives that can benefit from such expertise."[206]

In 2002, the FSA published a discussion paper (DP 16) stating that it would not prohibit the marketing of hedge fund products and services to the public as long as they abided by certain regulations.[207] The FSA stated that only "authorized persons" who abide by the "collective scheme

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[199] *Id.*

[200] *Id.* at 45123.

[201] Revision of Limited Offering Exemption Release, *supra* note 129, at 45123.

[202] *Id.* at 45126.

[203] Michael J. Schmidt, Note, *"Investor Protection" in Europe and the United States: Impacting the Future of Hedge Funds*, 25 WIS. INT'L L.J. 161, 181 (2007).

[204] *Id.*

[205] *Id.*

[206] *Id.*

[207] Tiffith, *supra* note 9, at 520.

requirements" may conduct general solicitations.[208] More specifically, one of these requirements is that funds have to be authorized by the FSA.[209] The other requirement is that funds report "particulars" about their investment strategies.[210] Not surprisingly, most hedge funds are not authorized because they strongly oppose the latter requirement for fear that their novel strategies will become public knowledge.[211]

In light of hedge fund growth on a global scale, the increase in hedge fund fraud, and the increased role of hedge funds in providing market liquidity, the FSA decided to reevaluate its regulatory framework of hedge funds.[212] In 2005, the FSA published two discussion papers (DP) concerning the risks and potential problems caused by hedge funds.[213] DP 05/03 focused on the risks consumers are exposed to as a result of the growing "retailization" of private investment pools, such as hedge funds.[214] DP 05/04 focused on risks and concerns related to hedge funds and the manner through which the FSA should address these risks and concerns.[215] More specifically, the paper identified numerous potential key risks. First, the FSA expressed concern about potential serious market disruption and erosion of consumer confidence, not only in hedge funds but also in their creditors and counterparties.[216] Second, the FSA was also concerned about the possibility of liquidity disruption leading to disorderly markets.[217] Moreover, the FSA stated that the inadequacy of methodologies to evaluate risk and imprudent risk management were areas of concern.[218] The FSA highly recommended that hedge funds establish and maintain significant stress testing procedures.[219] Finally, the FSA stated that deficiencies in asset valuation methodologies and inadequate information systems were of concern because they created a "significant potential for ill-informed investment decisions."[220] The FSA solicited comments from market

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[208] *Id.*

[209] *Id.*

[210] *Id.*

[211] *Id.*

[212] *Id.* at 521.

[213] Schmidt, *supra* note 203, at 181.

[214] *See generally* Financial Services Authority, Wider-range Retail Investment Products—Consumer Protection in a Rapidly Changing World (June 2005), *available at* http://www.fsa.gov.uk/pubs/discussion/dp05_03.pdf [hereinafter DP 05/03].

[215] *See generally* Financial Services Authority, Hedge Funds: A Discussion of Risk and Regulatory Engagement (June 2005), *available at* http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf [hereinafter DP 05/04].

[216] *Id.* at 6.

[217] *Id.*

[218] *Id.*

[219] *Id.*

[220] *Id.*

participants on whether the risks it identified in DP 05/04 were correct and whether any of the risk mitigation recommendations it made warranted further analysis.[221]

In March 2006, the FSA published Feedback Statement 06/02 (FS 06/02) setting out the responses that it received for the questions it posited in DP 05/04. The FSA concluded that it would not institute any new regulations on hedge fund advisers unless there is a market failure requiring regulatory remedies.[222] The FSA found two areas in which it believed there was a market failure.[223] The FSA identified the first market failure where the adequacy of asset valuations is difficult or impossible to evaluate due in large part to hedge funds' investments in illiquid financial instruments.[224] This market failure would be further amplified where fund managers have conflicts-of-interest or have an incentive to manipulate asset valuations.[225] The FSA identified hedge funds' uses of side-letters[226] as the second market failure.[227] Referring to side-letters, the FSA said that "[t]hese result in some, often large, investors receiving more information and preferential (early) redemption terms compared with other investors in the same share class (who may be unaware that side letters exist and who will be denied [the same] terms)."[228] After stating that the use of side-letters constitutes a breach of business integrity, the FSA went on to say that, "[a]s a minimum we would expect acceptable market practice to be for managers to ensure that all investors are informed when a side-letter is granted and any conflicts that may arise are adequately managed."[229] The FSA emphasized that it will further study hedge funds' use of side-letters and will establish regulatory measures if needed.[230]

B. European Union's Regulatory Framework of Hedge Fund-Like Investment Products

The European Union's approach to regulating hedge fund-like investment products is unique in that its primary objective is to create or promote integrated investment products that are common to all member

[221] DP 05/04, *supra* note 215, at 65.

[222] Financial Services Authority, Feedback Statement on DP 05/04 Hedge Funds: A Discussion of Risk and Regulatory Engagement 7 (Mar. 2006), *available at* http://www.fsa.gov.uk/pubs/discussion/fs06_02.pdf [hereinafter FS 06/02].

[223] *Id.* at 7.

[224] *Id.*

[225] *Id.*

[226] *Id.*

[227] *Id.* at 6.

[228] FS 06/02, *supra* note 222, at 6.

[229] *Id.*

[230] *Id.*

states.[231] Investor protection is also an objective insofar as it promotes a common investment method for investors throughout the European Union.[232]

Undertakings for Collective Investment in Transferable Securities (UCITS), which account for 70% of the managed assets in Europe, are similar to U.S. mutual funds.[233] Although traditionally these funds were limited to using investment in derivatives as a risk management tool, they are now free to invest heavily in derivatives after the passage of the UCITS III legislation.[234] However, UCITS III investment products are far more heavily regulated than any hedge fund is in the United States or the United Kingdom.[235]

With the heightened regulatory oversight of UCITS III funds comes greater investor protection.[236] For retail investors, who are largely locked out of the U.S. and the U.K. hedge fund markets, UCITS III funds provide the best of both worlds in that they offer investors hedge fund-styled investments with the heightened regulatory oversight of UCITS III.[237]

The European Union is unclear as to the level of systemic risk that hedge funds pose, and thus, does not have a common regulatory scheme for hedge funds.[238] Although the European Union is focused on preventing regulatory fragmentation for the sake of improving cross-border marketability, it feels that it does not possess the knowledge to pass an informed regulatory framework.[239]

C. Germany's Regulatory Framework of Hedge Funds

Germany's regulatory approach, which is characterized by substantial regulatory measures, is interesting because it is diametrically opposite to the United States' approach.[240] The SEC's approach is indirect regulation with a prohibition on general solicitation of investors.[241] On the other hand, Germany allows public solicitation, while heavily regulating how hedge funds are managed.[242]

While it appears that Germany's regulatory scheme has had some

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231 Schmidt, *supra* note 203, at 177.
232 *Id.* at 178.
233 *Id.* at 177.
234 *Id.* at 177–178.
235 *Id.* at 178.
236 *Id.* at 178–179.
237 Schmidt, *supra* note 203, at 178–79.
238 *Id.*
239 *Id.* at 179.
240 *Id.* at 179–80.
241 *Id.* at 166–167.
242 *Id.* at 180.

success, it is crucial to point out that Germany's share of the hedge fund market is relatively small,[243] and thus the cost of regulation is lower than in other countries, such as the United States and the United Kingdom, which have relatively large shares of the hedge fund market.

V. COMPARATIVE ANALYSIS

A. Germany's Approach

Despite the fact that mandatory registration and regulation of hedge funds was struck down in *Goldstein*, such an approach would inevitably lead to hedge funds moving offshore or moving to other jurisdictions that are not as heavily regulated as the United States. For this reason, the German approach is not recommended, as it would threaten the United States' robust capital markets.

Germany is at peace with the risk of losing market share in the hedge fund market because its market share is minuscule.[244] In contrast, the SEC has recognized and appreciated the positive attributes of hedge funds, which include providing alternative forms of investment and greater liquidity, smoothing out pricing discrepancies, and reallocating risk to the most efficient risk bearer.

B. European Union's Approach

Although the European Union does not have much of an approach, it is nevertheless cautious and hesitant to implement any regulatory framework before having sufficient information about the hedge fund industry. The United States should consider adopting a more cautious approach that studies in detail the possible impact of regulatory measures before approving them.

In retrospect, it appears, and many scholars suggest, that the SEC's Hedge Fund Rule was implemented somewhat prematurely, and that the SEC should have conducted more research before deciding to approve it.[245] In fact, one scholar argues that there were psychological forces which drove the passage of the Hedge Fund Rule.[246] More specifically, he argues that after the near collapse of LTCM, the SEC felt the psychological pressure of

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243 Schmidt, *supra* note 203, at180.

244 On the other hand, the United States and the United Kingdom comprise 85% of the hedge fund market, and risk deflating their respective capital markets. Schmidt, *supra* note 203, at 187.

245 Daniel, *supra* note 1, at 272–73.

246 *See* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, Mission*, 2006 U. ILL. L. REV. 975 (2006) (arguing that after such scandals as Enron and Worldcom, the risk of fraud and other hedge fund abuses disproportionately affected the SEC, causing the agency to act when it had not in the past).

taking action, rather than exercising the caution required in the consideration of such a sweeping rule.[247]

C. United Kingdom's Approach

The United Kingdom's approach does not require registration unless a hedge fund plans to solicit to the general public. The United States' approach is the same with respect to public solicitations. However, this is where the similarities between the two approaches end.

The United Kingdom's approach, which is principles-based, is characterized by a risk-based monitoring scheme. This approach is effective and is narrowly tailored since it identifies hedge funds that pose the highest levels of systemic risk, and in turn monitors them. This is a practical approach since it would be impractical and inefficient to monitor funds that do not pose a risk. Moreover, this approach is more cost-effective than mandatory registration and regulation because resources are allocated based on the level of risk a fund poses. This approach is superior to mandatory registration because if hedge funds move offshore, then there will be a greater, more detrimental risk of limited or no oversight. The United Kingdom also requires that funds have independent third parties evaluate their valuation processes. This part of the United Kingdom's approach is discussed more in detail in part VI-A.

VI. RECOMMENDATIONS

In light of final Rule 206(4)-8, proposed Rules 216, 507 and 509, and the proposed revision to Rule 501(a), it appears that the United States has not abandoned its pre-*Goldstein* rules-based approach in regulating hedge funds. The United States' rules-based approach is deficient because it does not go far enough with respect to requiring independent fund valuation, falls short of gathering adequate information about hedge funds, fails to take a risk-based approach, and, like the United Kingdom, also fails to address the threat of empty voting.

A. Independent Valuation

One way of ensuring investor protection is through independent, third party valuation of hedge funds' assets, especially when hedge funds are heavily invested in illiquid assets.

Currently, the United States relies solely on hedge fund managers' valuation processes, and does not require independent evaluation of these processes.[248] Although Principle 9.2 of the 2007 PWG Report advises

[247] *Id.*

[248] Schmidt, *supra* note 203, at 184.

managers to comply with "industry sound standards" in establishing valuation procedures, it seems that the onus is placed on the shoulders of investors, creditors, and counterparties to inquire into a fund's valuation procedures.[249] In contrast, the United Kingdom's FSA requires that an independent third party value a fund's assets.[250] Moreover, the FSA strongly stresses improved standards in valuation procedures of hedge funds. However, one constraint is that the effectiveness of independent valuation may be limited by a fund's illiquid and off-balance sheet investments, in which case a regulatory body would have to rely on a manager's valuation.

Nevertheless, the United States should consider adopting the FSA's policy on independent third party valuation and emphasis on improved valuation procedures.

B. Registration and Reporting Requirements

In light of *Goldstein*, the United States cannot regulate hedge funds through mandatory registration and reporting requirements. Although the Hedge Fund Rule may have been excessive in terms of its regulatory scope, it is unlikely that the United States will be able to set up any type of effective system of oversight without the ability to collect information about hedge funds and their investment strategies.

The current approach that the United States has adopted in attempting to overcome this obstacle is to advise investors to "obtain accurate and timely historical and ongoing material information necessary to perform due diligence regarding the pool's strategies, terms, conditions, and risk management, thereby enabling such investors to make informed investment decisions."[251] This approach is flawed for two reasons. First, it is unlikely that investors, including sophisticated investors, will have sufficient expertise so as to be able to evaluate such information and make informed decisions. Second, this approach neglects the old adage that lessons of the past, such as the near demise of LTCM, are easily forgotten, especially during market upswings. Thus, during such times, investors are less likely to scrutinize information provided by managers. In contrast, one reason U.K. hedge fund regulation has become the paradigmatic hedge fund regulatory framework is because U.K. hedge fund managers are subject to reporting requirements and monitoring by the FSA.[252] An all-or-nothing

[249] *See* 2007 PWG STUDY, *supra* note 54, at 5 (failing to indicate how specific compliance procedures should be implemented).

[250] Schmidt, *supra* note 201, at 183.

[251] *See* 2007 PWG STUDY, *supra* note 54, at 2.

[252] *See* Schmidt, *supra* note 203, at 185–187 (arguing that U.K. regulations focus on monitoring and safeguarding against the influences of systematic risk may make it the leader in hedge fund regulation).

approach to requiring registration and reporting is unlikely to lead to an effective system of oversight.

Thus, the SEC should consider policies or measures that incentivize hedge funds to voluntarily register with the SEC.

C. Risk-Based Approach

One of the hallmarks of the United Kingdom's principles-based approach is the informal processes that allow for oversight, such as negotiations and compromises between hedge fund managers and the FSA. Although this approach may not be feasible for overseeing an *entire* market of hedge funds, it is an effective approach when used to reach out to the funds that have the most impact on the market and thus pose the greatest systemic risk.

The FSA has created what has come to be known as a "center of hedge fund expertise" (the Center) to supervise the fifteen to twenty-five hedge funds that have the largest impact on the market.[253] The Center is responsible for "relationship management of high-impact hedge fund managers, driving relevant thematic work and supporting authorization, enforcement and policy initiatives that [can] benefit from such expertise."[254] This approach is effective for two reasons. First, it is cost-effective since it focuses on the funds that have the most effect on the market. Second, it provides an opportunity to establish a relationship of trust with the industry, which could lead to greater transparency, greater accuracy in disclosures, and ultimately better protection for investors.

Under the U.S. approach, regulators are encouraged to "take full advantage of both formal and informal channels of coordination and cooperation across financial industry sectors . . . ."[255] Although this approach is a step in the right direction, it falls short because it lacks concrete structures for its implementation, in contrast to the U.K. approach.

D. Address the Threat of Empty Voting

As discussed earlier in this note, the practice of empty voting, a term coined by Henry Hu and Bernard Black, refers to where an investor holds more votes than his or her economic ownership.[256] Generally, corporate law makes voting power proportionate to an investor's ownership stake in a company.[257] This is a fundamental tenet of corporate governance because it

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[253] Tiffith, *supra* note 9, at 524.

[254] *Id.* (quoting Financial Services Authority, Hedge Funds: A Discussion of Risk and Regulatory Engagement 41 (June 2005)).

[255] *See* 2007 PWG STUDY, *supra* note 54, at 6.

[256] Hu & Black, *supra* note 39, at 812.

[257] *Id.* at 811.

enables investors to hold directors and managers accountable. In other words, the coupling of ownership and voting power enables investors to ensure that directors are managing the company in such a way as to ensure that the long-term profits of the company are maximized.

However, recent capital market developments allow outside investors and corporate insiders to "decouple" voting power of a security from its ownership interest.[258] Some hedge funds have been active in the decoupling of interest and voting. In extreme cases, funds may hold the right to vote a large block of votes without having any economic stake in a company.[259] The practice of empty voting has troubled regulators and investor advocacy groups for a couple of reasons. One reason is that it enables hedge funds to interfere with corporate governance by allowing them to block or to approve corporate takeovers or mergers. Another more disturbing reason is that the practice allows for the creation of perverse incentives, such as profiting through market manipulation. For example, a hedge fund may have investments in a position counter to that of the company, and thus would have an incentive to vote its shares in a way that is detrimental to the long-term financial success of the company for the sake of short-term profits.

With respect to regulation, neither the FSA nor the SEC has addressed the practice of empty voting.[260] Thus, the United States as well as the United Kingdom should consider adopting disclosure measures that require hedge funds to reveal not only voting power, but also their ownership interest in a company.[261] Moreover, since empty voting is international in scope, the United States should consider coordinating their oversight system with those of other countries, especially the United Kingdom.[262]

VII. CONCLUSION

In light of final Rule 206(4)-8, proposed Rules 216, 507 and 509, and the proposed revision to Rule 501(a), it appears that the United States has not abandoned its pre-*Goldstein* rules-based approach in regulating hedge funds. Moreover, the United States' rules-based approach has proven to be deficient in several respects. First, the U.S. approach does not go far enough with respect to requiring independent fund valuation. In addition, it falls short of establishing an information-gathering mechanism that contributes to investor protection. Moreover, the U.S. approach does not allocate regulatory resources based on the relative risk that a hedge fund

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[258] *Id.* at 812.

[259] *Id.*

[260] *See* Scannell, *supra* note 39 (noting that both the SEC and the FSA have expressed concerns over the effect empty voting may have on protecting voters' interests).

[261] Hu & Black, *supra* note 39, at 876.

[262] *Id.* at 886.

poses. Finally, the United States, like the United Kingdom, has not addressed the potential risks that accompany the practice of empty voting.